CHAPTER VI

# THE SIZE AND DISTRIBUTION OF GAINS FROM QUALIFIED PLANS: OPTIONS FOR FURTHER LEGISLATION

As previous chapters have shown, the tax advantages of qualified plans make possible large overall gains in retirement income. The gains, however, are unevenly distributed. Projections suggest that about half of the extra income from the tax advantages of present plans will go to those in the top quartile of the income distribution, and over 70 percent to those in the top half. The projections show even larger disparities in the gains between workers with 20 or more years under one plan and those with shorter tenures. Yet all workers pay for the tax advantages of qualified plans through higher tax rates or forgone public services. Policies to reduce the disparities in gains might therefore be considered. In addition, providing boosts in retirement income and incentives for increased saving--however equitably distributed--are not, of course, the sole, or even foremost, purposes of government. Those objectives must be weighed against other imperatives and values such as national defense and international commitments, competing domestic needs, and the present problem of large federal deficits. In light of these other objectives, it could be argued that the government ought to scale back its subsidies for retirement, especially among those higher in the income distribution.

This chapter examines some additional measures that the Congress might wish to consider should it decide to make further changes in the tax advantages of qualified plans, particularly in the size and distribution of those advantages.

## THE PRESENT DISTRIBUTION OF GAINS SEEN IN CONTEXT

The skewed distribution of gains from qualified plans must be seen in perspective. First, it reflects the underlying distribution of pension and profit-sharing payments, and the earnings on which they are based. Since the top quartile of employees receives more than half of all employment income in the economy, it is not surprising that retirement income based on earnings is similarly distributed. Second, higher earners encounter higher tax rates so that, by definition, the tax advantages of qualified plans are more valuable to them.

Third, and most important, the Social Security system--payments from which are about two and one-half times as large as those from qualified plans--does much to compensate for the vertical skewing in the distribution of the tax advantages under the plans. Generally speaking, most of the subsidies in Social Security redound to workers in the bottom quartile who receive the least from qualified plans. By the same token, most of the net losses in Social Security are borne by those in the top quartile who receive the most from qualified plans. If the net losses and gains of Social Security were counted along with the gains from qualified plans, the result might well show that government policies are producing relatively proportional increases in retirement incomes, on average, in any given earnings class.

Social Security does not, however, compensate for the horizontal skewing within each income class toward long-service workers. Although most workers will be participants in a qualified plan during some period of their working lives, only about half of full-time workers are covered by qualified plans at any given moment, a participation rate which has changed little over the last 15 years or so. For the long-service worker with 20 or more years under one plan, the retirement income gains associated with the tax advantages are considerable--projected to be anywhere from 18 percent to 30 percent of retirement income absent the preferences. In contrast, however, the gains for those who fail to achieve 20 years under a single plan are much less--only one-fourth to one-half as large under the same projection. For single people without long service under one qualified plan, the retirement income gains from the tax advantages are projected as virtually nonexistent, a conclusion that has particular impact for women and minorities. This job tenure skewing in qualified plans has three basic causes: plan rules in the areas of coverage, vesting, and integration; the failure of many employers to sponsor qualified plans of any sort; and the erosion of the real value of deferred annuities payable from defined benefit plans among workers who change jobs several times over their lives.

The Congress has repeatedly addressed the first cause. Over the past several years, it has reduced the extent to which plan rules can discriminate among employees. But because of the other two causes, the overall effect of these changes has likely been small. If a worker is not covered by a plan, changes in permissible plan rules have no meaning for him or her. Similarly, although stricter rules as to coverage, vesting, and integration will allow more participants some new benefits, the value of those benefits will be worth little unless earned relatively late in a worker's life.

The second cause of job tenure skewing--the fact that many employers do not sponsor qualified plans--has led some to propose that all employers and employees be required to participate in qualified pension plans. 1/ Such proposals raise questions such as whether enlarging the Social Security system might be preferable to establishing mandatory pensions; whether workers who change jobs several times would still be at a disadvantage under defined benefit plans; and what ought to be the role of government in insuring defined contribution deposits against investment and inflation risks. These questions involve retirement policy issues that are generally beyond the scope of tax issues discussed in this paper. (One proposal, that salary reduction plans be made more widely available, is discussed below.)

The third cause--the effects of job changing on outcomes from defined benefit plans--has not received much attention. And yet, because well over half of all participants in qualified plans are covered by defined benefit plans, which account for most of the benefit dollars, this factor probably has more to do with qualified plan outcomes than any other. Unless the rules for calculating defined benefit annuities, particularly with respect to preretirement inflation, are modified to take account of job changing, little can be gained from making further changes in the rules for covering, vesting, and integration. 2/

The following section examines five measures that would address the policy issues just discussed. The first two measures would decrease the tax advantages and, therefore, the revenue losses associated with qualified plans. The Congress might wish to consider such measures for several

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1. A proposal for a mandatory pension tier was put forward in 1979 by the President's Commission on Pension Policy. It would require that each employer place an amount equal to 3 percent of most employees' wages or salaries into qualified money purchase pension (defined contribution) accounts. An employer could maintain an additional qualified plan (or plans) if he or she wished to do so. See President's Commission on Pension Policy, *Coming of Age: Toward a National Retirement Income Policy* (February 26, 1981). A similar proposal has also been debated in the United Kingdom. See the While Paper *Reform of Social Security: Programme for Action* (London: Her Majesty's Stationery Office, Cmnd. 9691, December 1985), and the predecessor Green Paper *Reform of Social Security* in three volumes, Cmnd. 9517-19 (June 1985).

2. CBO estimates that for plans using entry-age normal cost financing, a further decrease in the permissible vesting period from five years to one year would raise aggregate annual plan costs by at most 3 percent. This estimate assumes a 4 percent annual inflation rate.

reasons: to compensate for revenue losses associated with other proposals to increase access to, or change the results from, qualified retirement plans; to finance increased spending on those elderly people who receive the least benefit from the combination of Social Security and qualified plans; or to achieve nonretirement objectives such as a lower deficit, a further lowering of tax rates, or increases in other spending programs.

Two other measures would alter the distribution of the tax advantages of qualified plans, either by changing the way defined benefits are calculated or by broadening access to tax-favored savings.

A final measure would involve increased public spending to help those who benefit least under the combination of Social Security and qualified retirement plans.

## MEASURES TO REDUCE REVENUE LOSSES FROM QUALIFIED PLANS

The tax advantages and revenue losses of qualified plans have two origins: earnings on which tax liability is deferred until retirement, and their tax-free buildup in qualified plans. Each of these sources accrues mainly to those in the upper half of the income distribution. Measures to curtail the amount of earnings that can be deferred tend to affect only those at the very top of the income distribution. In contrast, a measure to tax, to some degree, the investment earnings of qualified plans and IRAs would have a broader impact.

Either approach would probably result in less retirement income for the upper half of the population. Such people would be likely to compensate by retiring later in their lives, although some might continue to retire relatively early and accept a lower standard of living in retirement. 3/ Less well-paid employees might also lose retirement income, since most of the managerial decisions are made by upper-income people, who, if qualified plans became less attractive, might be less inclined to sponsor the plans.

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3. As discussed in Chapter IV, evidence as to the effect of the tax advantages of qualified plans on saving rates is inconclusive. It is possible that, faced with the prospect of less retirement income gains in qualified plans, some people might save more. In that case, the effects of curtailing the tax advantages of qualified plans would be a lower after-tax standard of living during their working years.

## Reduce Allowable Contributions to Qualified Plans

There is no obvious salary limit beyond which the government should not subsidize the acquisition of retirement income; nor is there any similar limit to the percentage of annual pay that ought to go into tax-favored plans. 4/ The Social Security wage base, however, probably represents an income level below which a cutback in qualified plan limits would be regarded as unreasonable. That wage base covers about 90 percent of all earnings in the country, so a cutback to that level would remove only the top 10 percent of earnings from qualified plan subsidies. The wage base is estimated to be $45,000 in 1988; this limit could be applied to defined benefit plan accruals beginning in 1988. A proportionate cutback in the defined contribution plan limit would be to $15,000 in 1988. Alternatively, the limits could be cut back to amounts that are between current law limits and the Social Security wage base; for example, $67,500 for defined benefit plans and $22,500 for defined contribution plans.

In addition, the amounts that can be set aside for any one individual in qualified plans could be cut back: as a percentage of final compensation in the case of defined benefit plans, and as a percentage of current pay in the case of defined contribution plans. A cutback in the percentage of pay that can be devoted to defined contribution plans to less than 15 percent would make it difficult for even prudent savers in the middle class to acquire, through qualified plans, retirement income sufficient to maintain previous living standards. Similarly, a cutback below 67 percent in the amount of final pay that defined benefit plans can replace would make it difficult for middle-class workers to achieve full replacement of their preretirement income. Alternatively, these limits could be raised to intermediate levels, such as 80 percent of final pay in the case of defined benefit plans and 20 percent of current pay in the case of defined contribution plans.

Table 26 presents some of these alternatives for reducing contributions and benefits, and shows how such reductions would affect federal revenues. 5/ The defined benefits limits of $45,000 or $67,500 would in-

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4. See footnote 9 in Chapter V for a discussion of the potential conflict between lower contribution limits and the funding objective of ERISA.

5. Because of data constraints, it was not possible to estimate the effects of lowering the percent of final pay that a defined benefit plan can replace or the percent of current pay that can be devoted to a defined contribution plan.

TABLE 26. REVENUE GAIN FROM LOWER SECTION 415 LIMITS (In billions of dollars)

| | 1988 | 1989 | 1990 | 1991 | 1992 |
|---|---|---|---|---|---|
| Dollar Limits for DC Plans of $22,500 and DB Limit Equal to 1.5 percent of Social Security Wage Base | 0.2 | 0.6 | 0.6 | 0.7 | 0.8 |
| Dollar Limits for DC Plans of $15,000 and DB Limit Equal to Social Security Wage Base | 0.9 | 2.5 | 2.8 | 3.2 | 3.6 |

SOURCE: Congressional Budget Office.

crease according to increases in the Social Security wage base. The defined contribution (DC) limit, however, would be frozen at $15,000 or $22,500 until it is eventually cut back from one-third of the defined benefit (DB) limit to one-fourth, as the 1986 tax act provides. The revenue increases shown are for the five-year period 1988-1992.

## Limit Tax-Free Investment Income in Qualified Plans

Another way to reduce the tax advantages of qualified plans would be to impose a special income tax on the investment income accumulating in qualified plan trusts or annuity contracts and in IRA accounts--for example, a special income tax rate of 5 percent. 6/ For those in the 15 percent bracket, some 34 percent to 39 percent of the tax advantages would be eliminated, while only some 16 percent to 24 percent would be eliminated

6. In general, no credit or other offset for these taxes on the investment income of plans would be allowed against the taxes paid by the recipients of those distributions. As was demonstrated in Chapter I, most taxes paid on distributions are the postponed taxes on the original before-tax contributions. The calculation of the exclusion ratio under section 72, however, might have to be modified in order to avoid double taxation of the investment income earned by after-tax contributions.

for those in the 28 percent and 33 percent brackets. A tax rate greater than 5 percent would even more substantially decrease the value of tax advantages for employees in the 15 percent tax bracket compared with those in the 28 percent and 33 percent brackets. A 5 percent tax, therefore, probably represents an upper bound for a special tax of this type. A tax rate higher than 5 percent would also affect seriously the long-term interest rate assumptions in most qualified plan funding formulas. Table 27 shows the revenue effects of a 5 percent and a 2 percent tax rate. Because a tax of this type would have a greater effect on people in the 15 percent bracket than those in the 28 percent bracket, it might be desirable to accompany it with a cutback in the Section 415 limits. As before, the revenue estimates are for the five-year period 1988 to 1992.

TABLE 27. REVENUE GAIN FROM TAXING ASSET INCOME OF QUALIFIED PLANS (In billions of dollars)

| | Fiscal Years | | | | |
|---|---|---|---|---|---|
| | 1988 | 1989 | 1990 | 1991 | 1991 |
| Dollar Limits for DB Plans of $90,000 and DC Plans of $30,000 | | | | | |
| 2 percent tax rate | 0.9 | 1.4 | 1.5 | 1.6 | 1.7 |
| 5 percent tax rate | 2.1 | 3.6 | 3.7 | 3.9 | 4.1 |
| Dollar Limits for DB Plans of $67,000 and DC Plans of $22,500 | | | | | |
| 2 percent tax rate | 1.1 | 2.0 | 2.1 | 2.3 | 2.5 |
| 5 percent tax rate | 2.3 | 4.2 | 4.3 | 4.6 | 4.9 |

SOURCE: Congressional Budget Office.

## MEASURES TO PROTECT JOB CHANGERS

The tax advantages of qualified plans are disproportionately enjoyed by workers who stay under one plan for most of their working lives. This distribution may be a desirable compensation strategy for many employers, and society may benefit from it in terms of long-term commitments from workers to their firms and, consequently, increased national output. But it is questionable whether the income tax should subsidize, to the degree it does now, longevity rewards through the medium of defined benefit plans whose primary public purpose is to provide retirement income. Further, much of the skewing in defined benefit outcomes results from inflation, which is quite beyond the control and prediction of employers or workers.

Most workers are restricted in their choice of qualified plans to what their employers provide. Short-service workers and job changers generally cannot compensate for their comparative disadvantage in qualified plans by engaging in fully comparable tax-advantaged savings on their own. Workers whose employers have no qualified plan are at a similar, often greater disadvantage.

Two measures could address these disparities: eliminating inflation as a factor in the calculation of defined benefit deferred annuities; and further expanding access to qualified saving plans for uncovered workers and job changers. Before describing these alternatives, their major disadvantages are worth noting. First, they are potentially expensive and probably more disruptive of settled practices in qualified plans than anything else that the Congress has legislated, with the possible exception of the funding and fiduciary rules in ERISA. Second, they could seriously affect the labor markets by increasing job mobility, with uncertain effects on output and labor-management relations. On the other hand, many argue that the United States, now faced with increasing competition in the world economy, needs to encourage job mobility. These measures would arguably assist that end.

### Require Inflation Indexing in Defined Benefit Deferred Annuity Calculations

Under this proposal, the tax code would be amended to require that defined benefit plans adjust the salaries on which they calculate deferred annuities for inflation between the time workers separate from a plan until they are

first entitled to draw an annuity. 7/ (A deferred annuity is one that is owed a former worker who separates before retirement, once he or she reaches the plan's normal retirement age. In contrast, an immediate annuity is one that begins payments to a worker on leaving the plan at retirement.) Inflation indexing could apply either to all separated employees who are vested or to some narrower set of vested employees. By definition, it would apply to all workers in the event their plan was terminated.

To avoid requiring adjustments that exceed what separated workers would have received had they stayed with the firm, the increase in the index could be limited to price growth over the relevant period or to growth in the average of the firm's wages for workers covered by the plan, whichever was smaller. Similarly, to avoid requiring adjustments that exceed a plan's financial capacity, the index could also be limited to a measure of the plan's investment performance over the relevant time period, if that was lower. 8/

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7. In theory, a case can be made for requiring that the salaries of separated workers be adjusted for wage growth rather than prices alone. A wage index would eliminate virtually all differences in defined benefit outcomes between long- and short-service workers. Wage indexing, however, would require deciding whether the appropriate index should be society-wide (such as the Social Security wage index), firm-specific, or some combination of the two. In addition, if the relatively unpredictable factor of inflation were washed out of deferred annuity calculations, the remaining factor, real wage growth, would be more predictable and, therefore, more subject to explicit and rational bargaining between employers and workers. By the same token, therefore, additional governmental constraints about the remaining element--real wage growth--would become less necessary.

8 In addition, if the federal government were to require the indexing of salaries in final-pay defined benefit plans, employers might insist on having available a relatively riskless means of funding their deferred annuity liabilities. Short-term government notes would probably satisfy that demand. There have been periods, however, in which inflation has outstripped the return on short-term government bonds. If the government were to issue indexed bonds--that is, bonds whose rate of return is inflation plus a stipulated real interest rate--the demand could be satisfied under any circumstances.

Indexed bonds could also serve several other purposes relevant to retirement policy. First, for defined contribution plan participants, indexed bonds would provide a pre-retirement inflation-proof investment medium. Second, for defined benefit plans, defined contribution plans, or IRA holders, indexed bonds would provide a means to finance postretirement annuities with cost-of-living adjustments. Third, the availability of indexed bonds alone might lead some employers on a voluntary basis to provide deferred annuities based on indexed final salaries. For a recent discussion of indexed bonds, see Alicia H. Munnell and Joseph B. Grolnic, "Should the U.S. Government Issue Index Bonds," *New England Economic Review* (Sept.-Oct. 1986).

Presumably, plans would still be allowed to cash out deferred annuities whose present (or lump-sum) value fell below a particular dollar amount (currently $3,500). Such present value calculations would, however, necessarily be discounting the deferred annuity by the plan's real interest rate assumption, rather than, as now, its nominal interest rate assumption. 9/

Requiring that plans index salaries in their calculations would not affect their liabilities for normal retirement benefits--that is, the amounts a plan estimates it will pay workers who retire upon leaving employment under the plan. Liabilities for deferred annuities--that is, the amounts a plan must pay employees who leave employment under the plan sometime before the plan's usual retirement age--would increase by significant amounts. CBO estimates that annual costs for plans using entry-age normal cost financing would increase anywhere from 6 percent to 28 percent if those plans also had five-year vesting. These costs roughly equal 0.6 percent to 2.8 percent of annual compensation. If indexed deferred annuities were restricted to those with 10 years of service, the cost increase would be smaller--a 4 percent to 19 percent increase in annual plan costs, or amounts roughly equal to 0.4 percent to 1.9 percent of annual compensation. From one perspective, these costs may be viewed as relatively small--roughly equal to one year's typical wage increase. From another perspective, the costs may be viewed as large; if the increased costs were borne by workers entirely in reduced money wages, then some 0.4 percent to 2.8 percent of their lifetime compensation would be permanently shifted from current income to retirement benefits.

Alternatively, however, employers sponsoring defined benefit plans could compensate for these increased deferred annuity liabilities by eliminating or decreasing subsidized early retirement benefits, or by decreasing the benefit accrual factor in their plan formulas. If salaries in defined benefit calculations were indexed, subsidized early retirement benefits would be less necessary to motivate workers to leave beyond a particular age. To the extent that benefit accrual factors were reduced while aggregate costs were kept constant, there would be a redistribution of

9. Allowing lump-sum cash-outs would still leave workers somewhat at risk with respect to future inflation. If inflation turned out to be greater than what was assumed in the cash-out calculation, a worker receiving a preretirement lump-sum distribution would receive less than if, instead, he had been able to leave his accrued rights in the plan and received a deferred annuity. Conversely, if inflation turned out to be less than assumed in the the cash-out calculation, the plan would have paid more in present value terms as a lump sum than as a deferred annuity.

retirement income benefits away from long-service to short-service workers. Alternatively, the increased costs could be passed back to employees in the form of lower current compensation, some of which would be borne by short-service workers.

The employee lock-in effects now produced by defined benefit plans would be curtailed, though not entirely, under a system of price-indexed deferred annuities. Short-service workers and job changers would still lose the value of real wage growth in the calculation of their deferred annuities. On the other hand, workers would be somewhat more likely to move among employers, and, as a consequence, employers might find it less advantageous to invest in training and specialized equipment. To compensate, employers could provide explicit longevity incentives (for example, 20-year bonuses) or require that employees sign agreements to pay back the value of explicit schooling when they leave before a stipulated time period. These alternatives would tie productivity incentives less to retirement income, and would not involve tax subsidies.

Because present plans have not been funded with the expectation that they will pay deferred annuities on the basis of indexed salaries, imposing such a requirement for previous service could be very disruptive, even for plans with substantial reserves. Thus, any such requirement probably would have to be limited to accruals for future service under defined benefit plans. In addition, if retroactively applied, such a requirement would increase the federal government's exposure for pension liabilities insured through the Pension Benefit Guaranty Corporation.

The revenue consequences of this option are highly uncertain because one cannot be sure how employers might try to compensate for a requirement that they index final salaries in deferred annuity calculations in defined benefit plans. If all the costs of this change were borne by workers in the form of lower wage compensation, then the government would lose revenues on that fraction of compensation (anywhere from 0.4 percent to 2.8 percent) that shifted from being taxable to being nontaxable. That would constitute the upper bound of possible revenue losses. If the change was accommodated by a decrease in other aspects of the pension plan or other nontaxable compensation, then there would be no revenue losses.

The Congress could compensate for any negative revenue consequences of this proposal by curtailing Section 415 limits or imposing a minimum tax on the investment income of qualified plans, as discussed above. The revenue costs requirement would then be broadly borne by all

plan participants, including those who were gaining the most from the indexing change.

## Increase Access to Tax-Favored Retirement Saving

Another way of addressing the comparative disadvantages of short-service workers would be to increase their access to tax-favored saving independent of their employers. This increased access would also aid those not covered by a qualified plan of any sort. In theory, complete equality of access would be achieved if all workers could have IRAs up to, for example, the defined contribution limit of 25 percent of earnings or $30,000. 10/ A system of retirement savings along those lines, however, would not accommodate other objectives that the Congress sought to advance when it imposed conditions on qualified plans. Existing law, however, provides two models--salary reduction agreements and income-conditioned IRAs--that would increase independent access within the general framework of these other policy objectives. 11/

Salary reduction plans are similar to IRAs in that workers determine for themselves how much to put aside. Salary reduction agreements ("elective deferrals") are, however, subject to a special set of nondiscrimination rules and to the Section 415 rules that limit how much any one person can save on a tax-favored basis. 12/

To make tax-favored savings universally available within the overall framework of these rules, the federal government could require employers to give their workers the opportunity to execute salary reduction agreements. To comply, an employer would only have to offer his workers the option; as now, he would not be required to offer either matching or nonelective employer contributions. Because of the limits the law imposes

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10. For discussion of the merits of an unfettered large-scale IRA, see Richard A. Ippolito, *Economics and Public Policy* (Homewood, Illinois: Dow Jones-Irwin, 1986), chap. 12.

11. Both of these alternatives rely on the defined contribution approach to retirement savings with its accompanying investment and inflation risks to individual participants. The availability of government indexed bonds would, however, provide participants with a risk-free means to invest such savings. See footnote 8 for more discussion of indexed bonds.

12. There is one exception: in the nonprofit sector, employee elective deferrals are not constrained by these rules. See Chapter V, footnote 3.

on the deferrals of the highly compensated, however, without employer-matching contributions to encourage rank-and-file participation, the deferral opportunities for those at the upper end could be very limited. Consequently, as under current law, the highly compensated would be encouraged to persuade their employers to induce higher savings among the rank and file through matching contributions.

To further encourage matching contributions under universally available salary reduction agreements, the Congress could end IRAs, both deductible and nondeductible. The highly compensated would then be even more strongly motivated to persuade their employers to offer matching contributions. In addition, repeal of IRAs would offset the revenue losses from making salary reduction agreements generally available.

Requiring all employers to offer salary reduction agreements would be relatively unintrusive, especially when compared with such options as a mandatory minimum pension system. Nonetheless, it could bring with it some of the overhead costs and fiduciary duties that ERISA imposes on any qualified plan. 13/ Under current law, however, the administrative costs of qualified plans may be charged against employee accounts. ERISA also offers other options, such as self-directed accounts for each employee that could be used by employers to minimize their fiduciary exposure. In addition, banks, mutual funds, and other financial institutions have become increasingly willing to absorb the administrative and fiduciary costs of IRAs, Keoghs, and salary reduction plans. This trend would probably continue in a world in which salary reduction plans were universally available (and IRAs were limited).

A somewhat different approach, that would not necessitate any involvement by employers, would be to extend deductible IRAs from the current $2,000/$2,250 limits to, for example, the lesser of $7,000 or 25

13. A policy alternative that this paper does not address is a proposal to create centralized pension managers (or clearinghouses) for small business plans along the lines of the current TIAA-CREF system for employees of universities and similar institutions. One such proposal (Retirement USA) would authorize designated financial institutions to create megaplans into which small employers would contribute monies for their employees according to authorized formulas. Each employee would have his own account within such a megaplan. These institutions would invest these contributions and would assume the various reporting, disclosure, and fiduciary duties required by ERISA, thus keeping overhead costs for small employers at a minimum. By their nature, these proposals use the defined contribution approach to retirement savings.

percent of employment income, subject to the same phase-outs legislated in the Tax Reform Act of 1986. Unlike current law, however, this proposed $7,000 limit for deductible contributions, and the phase-out level for the deduction, would be indexed for inflation beginning in 1988. At the same time, nondeductible IRAs would be repealed. Under these circumstances, those with incomes greater than $40,000 to $50,000 (couples) and $25,000 to $35,000 (singles) would be strongly motivated to have their employers establish salary reduction plans with matching contributions. Otherwise they would have no independent access to tax-favored saving, and without matching contributions their colleagues below the IRA phase-out levels would have no incentive to participate in the salary reduction plans instead of saving solely through IRAs.

Short-service workers would be helped by either of those approaches. So would people working for employers--particularly small employers--who sponsor no other qualified plan, or whose plans offer relatively small benefits. Similarly, employees who are excluded from pension plan participation by coverage and vesting requirements could make more adequate provision for retirement on the same tax basis as those who are covered and vested. The same would be true for workers covered and vested in defined benefit pension plans but whose accrued benefits are very small. Younger and short-service employees could use salary reduction agreements (or larger income-conditioned IRAs) to hedge more effectively against the low probabilities of receiving much of value from their pension plans. 14/

A CBO estimate of the net revenue loss of universal salary reduction agreements and no IRAs appears in Table 28. The revenue loss from larger income-conditioned IRAs would be no greater and probably less. In addition, if the Congress wished to create more independent access to tax-favored saving on a completely revenue-neutral basis, either of these proposals could be accompanied by other offsetting measures--such as those described earlier that would lower Section 415 limits or impose a minimum tax on the

14. The federal government has recently enacted a new pension system that will afford its employees such opportunities. In addition to coverage under Social Security and a conventional defined benefit plan, new federal employees will be able to put aside, on a before-tax or salary reduction basis, 10 percent of their salaries into one of three "thrift plan" investment pools. The first 5 percent of a worker's salary reductions will be matched by a contribution from the employer agency. Thus, younger federal employees or middle-aged individuals who view their likely tenure with the federal government as limited will be able to accrue substantial retirement benefits through the thrift plan and thereby compensate for the low present value of their defined benefit rights.

investment income of qualified plans. Such a package would reduce the tax advantages for those who now benefit most from them, while increasing access for those who now receive the least from them.

Recent developments suggest that the United States may be moving rapidly toward nearly universal salary reduction agreements anyway. The Tax Reform Act of 1986 made it easier to create such arrangements by removing some impediments in the case of 401(k) plans and by authorizing salary reduction agreements in SEPs, although on a very limited basis. Since the act also eliminated deductible IRAs for those at the top end of the income distribution, financial institutions now have a stronger incentive to market no-load salary reduction plans to small employers and their workers.

## Increase Direct Spending on the Relatively Disadvantaged

Lower-income workers in general, and single people--the never-married and divorced--receive the least from qualified plans, in terms of payments and, especially, tax advantages. The fact that women workers and divorced wives are heavily represented in these groups does much to explain the relatively low incomes of single women in their old age. 15/ Qualified plans would have to be made mandatory in virtually all employment settings and be regulated even more than they are now in order to help low-income workers and women otherwise at risk. The government could, however,

TABLE 28 NET REVENUE LOSS FROM UNIVERSAL SALARY REDUCTION PLANS AND NO IRAs (By fiscal years, in billions of dollars)

| 1988 | 1989 | 1990 | 1991 | 1992 |
|---|---|---|---|---|
| 1.3 | 2.3 | 2.8 | 3.3 | 3.9 |

SOURCE: Congressional Budget Office.

15. An issue that is not well reflected in the data presented in Chapters II and III is the economic status of surviving spouses--especially widows. Because women usually outlive their husbands, they also often outlive the value of the assets that they and their husbands have accumulated for retirement, especially when

(continued)

increase the retirement income of these groups by changes in the Social Security and Supplemental Security Income (SSI) programs.

To finance such increases in Social Security or SSI outlays, the Congress could curtail the tax advantages of qualified plans along the lines discussed earlier (that is, reduce section 415 limits or place a tax on the investment income of qualified plans). Increases in the SSI program could be directly financed by the income tax revenues generated by these base-broadening measures. In the case of Social Security the additional revenues in the income tax could be used to reduce income tax rates, thus allowing a commensurate increase in the payroll tax rate to pay for increased Social Security costs without drawing upon general revenues.

The following discussion briefly outlines some illustrative proposals to increase benefits going to lower-income elderly people. Any number of other alternatives are possible.

Increase Social Security Benefits by a Uniform Amount. If the tax advantages of qualified plans were curtailed by lowering the contribution limits to levels tied to the Social Security wage base and by imposing a 5 percent special income tax on their investment income, then roughly $6 billion more could be made available in 1989 for spending in the Social Security program. That amount could be used to increase benefits paid to divorced spouses or to those retired workers (and their survivors) with the lowest wage histories. These ends could be accomplished either through substantial structural changes in the program (such as earnings sharing or a two-tier structure that combines a flat dollar amount with an earnings-

15. (continued)
they live into their eighties. As a result, many widows become poor or near-poor in those advanced years. A variety of measures have been proposed for changes in Social Security to ameliorate this situation. In addition, in the area of qualified plans, the conditions for a qualified joint-and-survivor annuity could be revised to reserve more of the annuity stream for the surviving spouse. These measures address, however, an issue that is not directly relevant to size and distribution of the tax advantages of qualified plans among workers; therefore, they are not examined in this paper. Note, however, that both of the spending alternatives discussed here--an increase either in Social Security or in the SSI basic benefit level--would assist older women in these circumstances. For more information about this issue and alternatives to address it, see Congressional Budget Office, *Earnings Sharing Options for the Social Security System* (January 1986); Department of Health and Human Services, *Report on Earnings Sharing Implementation Study* (January 1985); and the various studies and reports discussed in Appendix B of the latter report.

related benefit) or by incremental revisions of the program's current benefit formula and structure. Full discussion of such options is beyond the scope of this paper. 16/

Increases in Social Security benefits probably would redound only to those low-income households in which the primary earner had a long attachment to the labor force; unlike the SSI alternative discussed below, this would not help elderly low-income singles and couples who had no past labor force attachment. Some argue, however, that long-term low-wage workers should not have to be means-tested in order to have an adequate income in retirement; in this view, it would be preferable to increase the incomes of the low-income elderly through the Social Security system rather than through increases in the SSI program.

Increase the Federal Minimum in the Supplemental Security Income Program. Alternatively, the $6 billion (or less) that could be raised by limiting the tax advantages of qualified plans could be used to increase the federal basic benefit level in the SSI program to the poverty level or to extend that program's initial age of eligibility to age 62. 17/ Implementing both measures in the SSI program would cost no more than $6 billion in 1989, assuming that Medicaid eligibility was not also lowered to age 62.

Unlike increases in the Social Security programs, however, increases in the SSI benefit level would go to all the low-income elderly, regardless of their past attachment to the labor force. This distribution would be appropriate if the primary policy goal was to reduce poverty in a very targeted way. But it would include more people than those within the usual scope of policy concern of qualified plans and Social Security.

It should be noted that increases in the SSI basic benefit level and the Social Security program are not mutually exclusive. If undertaken together, the increased benefits in Social Security would decrease the amount of extra benefits provided through the SSI program. Increasing benefit levels in both programs would minimize the concern that long-service workers not be means-tested and would extend coverage to a broader population in poverty. The cost, however, would be higher than making changes in one program alone.

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16. See, for example, the studies cited in footnote 15 and in the publication of the 1979 Social Security Advisory Council, *Social Security Financing and Benefits* (December 1979).

17. Some of those between 62 and 65 are now on the SSI rolls because they are disabled.